

Supreme Court Upholds Constitutionality of the Public Company Accounting Oversight Board, Requires Changes to its Oversight Structure But Declines to Invalidate Sox

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On June 28, 2010, the Supreme Court announced its ruling in *Free Enterprise Fund, et al. v. Public Company Accounting Oversight Board, et al.*, 561 U.S. ____ (2010) requiring changes to the oversight structure by the Securities and Exchange Commission (SEC) of the Public Company Accounting Oversight Board (the PCAOB) but declining to invalidate the entirety of the Sarbanes-Oxley Act of 2002 (SOX). The Court found that the “for cause” removal oversight structure by the SEC of the PCAOB in SOX was an unconstitutional encroachment upon executive branch power; however, it held that such oversight structure was severable from the rest of SOX. Thus, what could have been a case with major ramifications for SOX compliance and securities litigation if decided differently will instead entail little, if any, practical change in those legal areas. The case is, however, a significant Constitutional separation of powers ruling.

Background on *Free Enterprise Fund*

On May 18, 2009, the United States Supreme Court granted certiorari in *Free Enterprise Fund, et al. v. Public Company Accounting Oversight Board, et al.*, 537 F.3d 667 (D.C. Cir. 2008). The case sought to resolve the constitutionality of the PCAOB, created as part of SOX in 2002. In June 2009, Paul Hastings issued a [client alert](#) examining the case and its potential impact on securities litigation. The case had the potential to invalidate the PCAOB, and perhaps even strike down SOX in its entirety.

The PCAOB is a private nonprofit corporation created to oversee the auditors of publicly traded companies. Congress created the PCAOB in the wake of accounting scandals at Enron, WorldCom, and other companies, as part of the SOX legislation. The PCAOB has regulatory and enforcement authority over all accounting firms that audit publicly traded companies.

The five members of the PCAOB are appointed by a majority of the five Commissioners of the SEC. But SOX specified that the PCAOB members may only be removed “for good cause” defined by the Act. 15 U.S.C. § 7211(e)(6). And, the Commissioners themselves can only be removed by the President “for cause.”

In *Free Enterprise Fund*, a nonprofit public interest organization (Free Enterprise Fund) and a Nevada accounting firm (Beckstead and Watts, LLP) brought suit against the PCAOB seeking declaratory and injunctive relief. Those plaintiffs made two arguments about SOX: (1) the PCAOB violated separation of powers by conferring executive power on Board members not subject to presidential control because they were not freely removable; and (2) Congress violated the Appointments Clause of the Constitution by giving the SEC the power to appoint members of the PCAOB.

The trial court granted the United States' and PCAOB's motions for summary judgment and found that PCAOB was constitutional, and the D.C. Circuit affirmed. The plaintiffs then sought and were granted certiorari.

The Supreme Court's Decision

The Supreme Court unanimously rejected the overall challenge to the PCAOB. But in a 5-4 opinion authored by Chief Justice Roberts, the Court ruled that the mechanism for removing PCAOB members was defective as it violated the Constitutional separation of powers.¹ Under SOX as written, PCAOB members were appointed by the SEC Commissioners, and could only be removed "for good cause." Likewise, SEC commissioners can only be removed by the President for good cause. Thus, the majority reasoned that there were two layers of good-cause restrictions on the President's ability to control the actions of the PCAOB. The Court rejected such an arrangement, noting that "[t]he result is a Board that is not accountable to the President, and a President who is not responsible for the Board." *Free Enterprise Fund*, 561 U.S. ____ (2010), slip op. at 14. Because the removal of executive officers is a key element of the President exercising his executive powers, the arrangement SOX created for the PCAOB "stripped" the President "of the power our precedents have preserved, and his ability to execute the laws – by holding his subordinates accountable for their conduct – is impaired." *Id.* at 15.

Although the case had the potential to invalidate the entire SOX law, the Court rejected the plaintiffs' argument on that point. The Court explicitly rejected the notion that the existence of the PCAOB violates separation of powers, and instead ruled only that its removal process was defective. *Id.* at 28. The Court proceeded to analyze the severability of the PCAOB's removal process from the rest of the law, and found it severable. The Court noted that unconstitutional provisions from otherwise constitutional laws were to be severed when possible, so long as the "remaining provisions are not incapable of functioning independently." *Id.* at 29 (internal quotations omitted). Finding that the rest of SOX was permissible and capable of functioning apart from the removal mechanisms originally established for the PCAOB, the Court ruled that SOX "remains fully operative as a law with these tenure restrictions excised." *Id.* at 28 (internal quotations omitted). But PCAOB members must now be removable by the SEC "at will." *Id.* Finally, the Court found no fault with PCAOB and the Appointments Clause, finding it permissible for the SEC to appoint PCAOB members. *Id.* at 33. Thus, the PCAOB will continue to function largely as it did prior to this litigation, albeit with more potential for SEC oversight.

Conclusion

PCAOB and SOX escaped *Free Enterprise Fund* relatively unscathed, with the Supreme Court requiring only greater executive ability to remove Board members. A case that could have had dramatic implications on SOX, PCAOB, and securities litigation ended with a whimper, not a roar. The practical effects of *Free Enterprise Fund* are likely to be minimal if any. The decision, however, is an important one for the Constitutional separation of powers.



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¹ The dissent found no constitutional defect in the removal provisions.